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ESTATE PLANNING — A NEW LEGAL SCIENCE

By

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During the past century, the scope of American jurisprudence has expanded tremendously due to a number of factors. Foremost among these has been the industrialization of economic life. This inevitably led to a shift from the investment of wealth in real property to its investment in intangibles and securities. Moreover, the new era gave rise to modern social and economic philosophies, imposing upon wealth larger responsibilities to the nation and its people. This

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last has taken a dual form. One, through restraints upon the use of economic power and the other, through taxation which assessed against wealth a larger proportion of the cost of government. Taxation, however, far outstripped economic restraints because of the more immediate needs of the nation to finance its recently assumed social responsibilities; and, later, to provide funds for the preparation and prosecution of the war. While the end of hostilities has reduced measurably our fiscal requirements, the governmental obligations remaining will necessitate taxation to continue at high levels for some time to come.

Simultaneously, the practice of law has expanded to meet these changed conditions. As a result, it has become a physical and mental impossibility for even the most conscientious general practitioner to keep abreast of all the developments in the profession. Within the last two decades, there has developed a marked trend towards specialization. The more known areas of specialization at present include administrative law, corporation, labor relations, negligence, utilities, insurance, estates and taxation. Taxation further divides itself into smaller spheres of more intense specialization.

ESTATE PLANNING

Among such specialties is estate planning. It has only recently commanded the interest of men of wealth. Its current importance reflects the magnitude of the changes which have taken place in our social and economic structure.

Until about 30 years ago, the lawyer called upon to advise his client in planning his estate had only to be concerned with the laws of devolution of the State in which he practiced. Insofar as the estate's prospective liability for estate and inheritance taxes was concerned, the lawyer was qualified to counsel his client if he kept himself informed of the property in the estate which, at the client's death, would be subject to State inheritance tax. The rates of tax were slight and the payment of such State inheritance taxes would not disturb seriously the client's plans for distribution of his estate.

In 1916, the Federal Government entered the field of estate taxation with the imposition of an estate tax based upon the value of the net estate transmitted at death by the decedent. At the present time, there are two Federal estate taxes imposed upon the estates of decedents. The first is the basic estate tax under the Revenue Act of 1926, superseded by the Act of February 10, 1939, which exempts estates up to a net value of $100,000. A credit of 80 percent of this basic Federal estate tax computed under its rates is granted to each estate for inheritance taxes paid to any State. The second is the additional Federal estate tax, as to which the Revenue Act of 1942 allows an exemption of $60,000 and is applicable to estates of decedents dying after the date of its enactment, October 21, 1942. This additional estate tax was first imposed by the Revenue Act of 1932 and the rates of tax under it have been progressively increased, while the exemptions granted to estates have been successively reduced. Both Federal estate taxes are assessed at increasing, graduated rates, according to the value of decedent's net estate.

The primary function of estate planning is not merely to minimize the tax burden. A flexible and well integrated estate plan calculated to serve the best interests of the client and his family may result in no tax benefits whatsoever and still be of inestimable value. It embraces the development and preservation as well as the ultimate distribution of estates. What in many instances would appear to a client to be simply a matter of drawing up a last will, may upon investigation turn out to be a highly complex problem involving business reorganizations, creation of trusts, life insurance, adjustment of tax difficulties, etc., and, finally, the drafting of a will. The lawyer must, therefore, constantly keep in mind the twofold concept of estate planning. One, the current objective, whose purpose is to arrange the property ownership within the family group so that it will bring to the owner and his family the maximum of enjoyment and security which such ownership can possibly provide. In this phase of estate planning, careful attention must be given largely to the operation of the Federal income and gift tax statutes so that the exactions of these laws will be reduced to their lawful minima and the benefits to the family unit thus correspondingly increased. To achieve this, the ownership of the property must be so divided that the benefits flowing from the property are distributed among the members of the family group in such manner that each member of the unit receiving the income shall report it in his own right. This is not the simple process it might appear to be. Lawyers familiar with the common law and tax law concepts of gifts and trusts have come to understand the thin line of demarcation that often separates success from failure, where efforts are made by the donor or settlor to retain a measure of control over the property, while the income is intended to be made available to other members of the family. It is axiomatic that to the extent that such measures succeed and result in a lessening of the income tax burden, the larger is the net amount of the income which remains for the use and benefit of the family unit.

The second phase of estate planning devotes itself to the disposition of the estate owner's property at death. Here again, the objective is to arrange the estate owner's affairs and his property ownership so that the maximum of such property, reduced by minimum estate and inheritance tax levies, shall be transmitted to his beneficiaries in a manner calculated to promote their best interests. In these arrangements, we collide with the Federal income, gift and estate tax statutes, with their insupportable conflicts which often result in the identical situation being subject to tax under each statute, successively. To lead the estate owner through this intricate and highly technical labyrinth of tax liability requires the guiding hand of a qualified expert, familiar not only with the applicable provisions of the Internal Revenue Code, the court decisions and the Treasury regulations and rulings, but one who also possesses a keen and analytical appreciation of the trends. The latter are sign posts along the road of his specialty pointing to future developments. The importance of this qualification becomes apparent at once when it is remembered that the Federal estate and gift tax laws are in their formative stages and in process of development; and that the action taken in reliance upon today's advice will not be reviewed for its tax implications until sometime later, perhaps years later. The expert who properly evaluates the trends in the changing tax scene will project their development in formulating his advice.

There is a present need for independent counseling in estate planning, divorced from all extraneous considerations other than the welfare of the estate owner and the compensation paid to the expert for his services rendered in preparing and presenting the estate plan. Associated with him would be the client's attorney and his accountant, the trust company and the insurance underwriter, where their services are indicated, all together forming a board of advisers and each bringing to the client the special qualifications which his experience has developed in his own field.

ESTATE SHRINKAGE

Every estate suffers shrinkage in amount. This is due to the payment by the executors of the decedent's debts, medical and burial expenses, executors' and legal fees, costs incident to the administration of the estate and the estate and inheritance taxes, both Federal and State, for which the estate becomes liable. What remains in the estate after the discharge of these items is then available for distribution to the intended beneficiaries in the manner directed under the estate owner's will.

The forces which tend toward the disintegration of wealth can no longer be overcome by the estate owner through the simple process of dawing and executing his last will and testament. A myriad of social, economic, financial and tax factors enter into the process and all these must be taken into account in our effort to preserve from undue shrinkage the results of the client's lifetime of labor—his estate.

It would be an impossible task to attempt to cover, even sketchily, the whole field of the broad concept of estate planning in one article. This dissertation will, therefore, deal primarily with the implications of the Federal Estate Tax which is the crucible through which the estate must pass and with which the estate planner must cope.

COMMON LAW CONCEPTS AND FEDERAL TAXATION

At the very outset, it is essential to point out that a proper understanding of Federal tax law must be based upon the realization by lawyers that many fundamental concepts generally accepted as part of the organic body of common law are often disregarded in Federal taxation. To the uninitiated who think of trusts, gifts, future interests, consideration, etc., in terms of their definitions at common law, it will come as a shock to learn that for Federal tax purposes these terms may carry entirely different connotations.

The development of this process in the law of federal taxation stems from the necessity of protecting the public revenue. To achieve this, a uniform system of national taxation must be evolved which will apply equally to taxpayers in like situations, unaffected by their places of residence within the United States. Merely to state this proposition is to establish its justification.

The law of federal taxation is fluid and in its formative stages. Its principal aspects are not more than 30 years in the making. Its underlying concepts are flexible, permitting their extension or contraction in accordance with the national objectives in taxation sought to be attained. Changing conditions and revised governmental policies as reflected by the rulings of the Treasury Department and the enactments of Congress frequently shift the emphasis, or broaden or restrict the scope of its application.

The confusion results from two principal causes. First, Congress in drafting tax legislation often uses familiar legal terms which have acquired accepted definitions in local law. However, these terms are given definitions under the respective tax statutes which differ materially from those ascribed to them under local law. While this creates confusion, it is an inescapable consequence of building the structure of the law of federal taxation with tools of legal terminology fashioned for, and for centuries adapted to, other types of business transactions. The alternative would be the creation of a new vocabulary of legal terms with the attendant perplexity which would accompany such a change. One is inclined to believe that the cure would be worse than the disease.

Secondly, the confusion is increased by the decisions of the courts upon which falls the task of interpreting the statutes. It is inevitable that in the attempt on the part of taxpayers to escape or lessen the weight of their taxes and the simultaneous effort of the taxing authorities to collect the taxes considered by them to be due, there is an unpreventable clash of interests. The courts must then decide whether or not the particular transaction comes within the intended scope of the statute which imposes the tax. Many times the statute uses language which, if applied in its ordinary business sense, would produce a result that would make the tax law ineffective to accomplish the purpose which the courts believe Congress intended. In such cases it would seem fair to say that the courts are not engaged in upsetting common-law concepts but rather that common-law limitations are not necessarily to be applied in the field of federal taxation.

THE PROBLEM ILLUSTRATED

TRUSTS

A few illustrations will point up the problem. In the law of trusts, the basic concept under common law recognizes the separation of legal and equitable interests. This line of demarcation, however, is not accepted in many instances for federal tax purposes. In Helvering v. Clifford, 309 U. S. 331 (1940), the Supreme Court announced some new and advanced principles of trust economics and federal taxation. There, an irrevocable trust was created by a husband with income payable to his wife for a term of five years, at the end of which the corpus was to be returned to him. As Trustee, he retained broad powers of management. The court held that where there is a short-term trust set up in an intimate family group, the transaction will be subject to special scrutiny for federal tax purposes. The economic realities of the situation will be considered so that if the bundle of rights equitably and legally enjoyed by the family group before and after the transfer remains the same for all practicable purposes, the income of the trust will be treated as taxable to the settlor despite the creation of the trust. This decision was handed down in the case of a short-term trust, but its rationale has been extended by later decisions so that the term of the trust is no longer a factor. A direct and concise statement of this philosophy is to be found in what Judge Jerome Frank said in Commissioner v. Buck, 120 F. (2d) 775 (CCA-2, 1941): "We are admonished, too, that 'ownership' is not a term of inflexible meaning, and that what is relevant to 'ownership' in determining the niceties of rights or duties under the rules concerning trust estates may need to be disregarded in applying the cruder test of taxability; in the law of trusts the cutting edge of the pertinent rule must be razorsharp, while in income tax law . . . the helpful image is rather that of a broad-sword."

Similarly, in the case of reciprocal trusts—that is, where each settlor creates an irrevocable trust, the benefits of which inure to the other settlor—the taxing authorities, supported by the decisions of the courts, treat the transaction as though each settlor had created the trust for himself. The trust property is included in his gross estate for federal estate taxation: Estate of Mary M. Cole, Deceased, v. Commissioner, 140 F. (2) 636 (CCA-8, 1944); and the beneficiary may be considered for federal gift tax purposes the donor of a reciprocal trust formally created by another: Commissioner v. Warner, 127 F. (2d) 913 (CCA-9, 1942).

PARTNERSHIPS

Similarly, the common-law concept of a partnership is disregarded and the partnership unit taxed as a corporation where, despite its validity under local law, the partners in their agreement have delegated authority to several of their number to carry on the business for them and the partnership is not dissolved upon the death of any of the partners: Regulations 111, section 29.3797-4; or a partnership between husband, wife and children may be disregarded for federal income tax purposes even though it is effectively created under state law because of the control retained over the partnership interests given by the husband to such members of the family: Losh v. Commissioner, 145 F. (2d) 456 (CCA-10, 1944); or because the husband's economic position remained unchanged after the transfer of the interest in his business to his wife and the formation of a partnership between them: Lusthaus v. Commissioner, —U.S.—(1946); Tower v. Commissioner, —U.S.—(1946). Furthermore, a partnership between husband and wife may be recognized under federal tax laws even in those states where husband and wife may not be partners: Felix Zukaitis, 3 TC 814 (1944); Willis B. Anderson, 6 TC, No. 123 (1946).

CONSIDERATION

In Merrill v. Fahs, 324 U. S. 308 (1945), the Supreme Court announced an entirely new definition of "adequate and full consideration in money or money's worth." Those of us who practice in the state courts have regarded it as hornbook law that the consideration necessary to support a valid transaction under common law could either be a benefit to the promisor or a detriment to the promisee. In this case, however, the Court declared that this is not to be the definition of "adequate and full consideration in money or money's worth" under the federal estate and gift tax statutes because the consideration necessary for such a transaction must result in a "benefit to the transferor." That it may be a detriment to the transferee is of no consequence.

FUTURE INTERESTS

Another instance is the definition and treatment of "future interests." Under the federal gift law, the concept of future interests in the law of property, which includes vested and contingent remainders, is totally disregarded. Under state law, a vested interest is regarded as a present, matured interest in property. In applying the federal gift tax statute, a vested remainder is, nevertheless, a future interest if the enjoyment and possession of it are postponed to a future date. Hence, the annual exclusion is not allowed for such gifts. In Helvering v. Hallock, 309 U. S. 106 (1940), the Supreme Court stated that future interest concepts under common law are the product of a medieval feudal economy founded upon land as its principal item of wealth while the basis of wealth in our modern economy rests largely upon intangibles and should be treated differently.

GIFTS

One of the elements necessary under common law to create a valid gift is the so-called "donative intent"—the intention on the part of the donor to make a gift. The Supreme Court in Blair v. Commissioner, 300 U. S. 5 (1937), held that the elements necessary for a valid gift were to be determined by local law. Earlier, in Burnet v. Guggenheim, 288 U. S. 290 (1933), Mr. Justice Cardozo declared that the transfer must have the quality of a gift. Yet, in Commissioner v. Wemyss, 324 U. S. 303 (1945), the Supreme Court, interpreting the pertinent provision of the federal gift tax statute, stated that the presence of the donative intent is not necessary to establish a transfer as a gift. The tax attaches to the value of the property which the donor transfers in excess of "money's worth" received by him: Section 1002, Internal Revenue Code (formerly Section 503, Revenue Act of 1932).

In the light of these changes in our preconceived notions of the common law, we can now discuss the Federal Estate Tax.

INCREASED RATES OF TAXATION AND REDUCED EXEMPTIONS

The rates of Federal Estate Tax have been increased from time to time. Under the Revenue Act of 1926 which imposed the Basic Estate Tax, the net estate after the exemption of $100,000 was subject to tax at graduated rates which were inconsequential and innocuous. They were: 1% on the first $50,000; 2% on the next $50,000; 3% on the next $100,000; 4% on the next $200,000, etc., with a maximum of 20% on a net estate of $10,000,000 and over. For the purpose of the Additional Estate Tax, the net estate after the specific exemption of $60,000 is taxed at rates which increase progressively and sharply as the size of the estate mounts. The rates range from 3% on the first $5,000 of the net taxable estate to 28% on estates between $60,000 and $100,000 and so on up to 77% on estates of $10,000,000 and over, each bracket of the net estate being subject to tax at the applicable rate for such bracket. The present rates represent a sharp increase over those which were in effect prior to September 21, 1941, which already included an additional 10% Defense Tax applicable to decedents dying after June 25, 1940 and before September 21, 1941. The combined effect of the reduced exemptions discussed above and the increase in estate tax rates has been to impose a heavier burden of such taxation upon a greater number of estates.

THE CONCEPT OF THE GROSS ESTATE

Under Section 811 of the Internal Revenue Code, there is included in the decedent's gross estate the value of all property of the decedent at the time of his death. The concept of the "gross estate" has been continually expanded by enactments of Congress, the decisions of the Federal Courts and the Regulations, rulings and decisions of the Treasury Department. The result of these changes has been to compel inclusion in the decedent's gross estate for Federal Estate taxation of many types of property which under local law are either exempt from inheritance or estate tax or are not includible as part of the decedent's estate.

The property of the decedent is included in his gross estate to the extent of:

(a) The decedent's interest therein at the time of his death and passing by Will or under the intestate laws: I.R.C. Sec. 811(a).

(b) The interest therein of the surviving spouse existing at the time of the decedent's death as dower, curtesy or statutory substitute in lieu thereof: I.R.C. Sec. 811(b).

(c) Any interest therein of which the decedent made a transfer, in trust or otherwise, (1) in contemplation of death or (2) to take effect in possession or enjoyment at or after death; or under which he has retained for his life (a) the possession or enjoyment of or the right to the income from the property, or (b) the right either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom, except in case of a bona fide sale for an adequate and full consideration in money or money's worth. There is a presumption that any transfer of a material part of the decedent's property within two years prior to his death without adequate or full consideration was made in contemplation of death: I.R.C. sec. 811(c).

GIFTS IN CONTEMPLATION OF DEATH

In determining whether a gift was made in contemplation of death, the decedent's motive is the controlling factor. The Supreme Court in United States v. Wells, 283 U.S. 102 (1931), defining the term "in contemplation of death", said:

> ". . . the reference is not to the general expectation of death which all entertain. It must be a particular concern giving rise to to a definite motive. . . . The motive which induces the transfer

must be of the sort which leads to a testamentary disposition. Old age may give premonitions and promptings independent of mortal disease. Yet, age in itself cannot be regarded as furnishing a decisive test, for sound health and purposes associated with life, rather than with death, may motivate the transfer. . . . The dominant purpose of the section is to reach substitutes for testamentary dispositions and thus prevent the evasion of the estate tax."

Although in ascertaining the decedent's motive the test is necessarily subjective, there are four objective facts which are usually material. They are (1) the decedent's physical condition, (2) his age, (3) the size of the transfer and (4) the time interval which elapsed between the transfer and his death. Of these, the state of decedent's health at the time of the transfer is the single most definite objective criterion. Gifts made by persons between the ages of 80 and 90 have been held not to have been made in contemplation of death where the donors were in good physical condition and there was evidence that the motives which induced the transfers were associated with life:

Commercial National Bank, 36 BTA 239 (1937).
Smart v. U. S., 23 F. (2d) 188 (1927).

MOTIVES ASSOCIATED WITH LIFE

To determine decedent's motive, all the myriad of circumstances attending the particular transfer must be carefully scrutinized. Motives associated with continuance of life defeat the operation of this section. For example, the desire to teach one's children how to handle money and to avoid the annoyance of their frequent money demands (Wetherill, 36 BTA 1259 (1937)); to induce children to enter the business of the parent (Willcuts v. Stoltze, 73 F. (2d) 868 (CCA-8, 1934)); to provide a means of support for a divorced daughter and her family (Estate of J. B. Bryan, T. C. Memo. op. Dec. 13, 171(M) (1943)); to improve the financial circumstances of his children (Kroger v. Commissioner, 145 F. (2d) 201 (CCA-6, 1944)); to give donees the opportunity to enjoy the property during donor's lifetime (Margaret Fair, Executrix, v. U. S., 59 Fed. Supp. 801 (W.D. Pa., 1945)); to procure competent management for her property (Cushman Estate, 40 BTA 947 (1939)); to provide his wife with an independent income (McGregor v. Com'r., 82 F. (2d) 948 (CCA-1, 1936)); to reduce income taxes, avoid gift taxes and equalize the income of decedent and his wife (Becker v. St. Louis Union Trust Co., 296 U. S. 48 (1936)); Constance McCormack, 38 BTA 308 (1938)); Kneeland, 34 BTA 816 (1936)).

MOTIVES ASSOCIATED WITH DEATH

Motives which have been held to be associated with death and, therefore, cause the transfer to be includible in the gross estate embrace the desire to escape estate taxes: Reg. 105, Sec. 81.16; Commonwealth Trust Co. of Pittsburgh v.

Driscoll, 137 F. (2d) 653 (CCA-3, 1943), cert. den. 321 U. S. 164 (1944)). Thus, the transfer of insurance policies by a decedent who was 45 years old at the time and in good health for the express purpose of avoiding estate taxes was held to be in contemplation of death: Slifka v. Johnson, 63 Fed. Supp. 289 (D.C.S.D.N.Y., 1945).

On the other hand, in the recent case of Allen v. Trust Co. of Georgia, —U.S.—(1946), the decedent made several gifts in trust in 1925, reserving the right to amend, but not to revoke, the trust. Upon being advised that the reservation of such a power would cause the trust property to be includible in his gross estate and thus subject to estate taxes, the decedent relinquished the power in 1937, at the age of 81 and within two years of his death. The Supreme Court reasoned that the decedent, a lawyer, at the time he created the trusts did not believe that the reservation of such a power would require their inclusion in his estate. Upon learning to the contrary, he released the power in order to accomplish what had been his original intention—namely to make complete and absolute gifts to his children freed of all claims, including taxes. It, therefore, held that the two year presumption that the release was made in contemplation of death was overcome.

Transfers for the purpose of barring dower and curtesy rights are held to be in contemplation of death: Kroger v. Commissioner, 145 F. (2d) 201 (CCA-6, 1944); Estate of Marion S. Gane, T. C. Memo. op. Dec. 14, 311(M) (1945).

The making of a gift at the same time and in the same proportions as the decedent's will is a persuasive indication that the transfer was in contemplation of death: Igleheart v. Commissioner, 77 F. (2d) 704 (CCA-5, 1935).

In dealing with the subject of gifts, it is important to remember that the Federal Gift Tax law allows taxpayers an annual exclusion of gifts to the value of $3,000 to each donee without limit as to number, and a specific exemption of gifts to the amount of $30,000 for his entire lifetime: I.R.C., Sec. 1003, 1004.

Furthermore, if a gift is subsequently held to have been made in contemplation of death and thus includible in the gross estate of the decedent, the gift tax paid will be available as a credit against the estate tax: I.R.C., Sec. 813(a), 936(b).

TRANSFERS TO TAKE EFFECT AT DEATH

The section of the Code dealing with transfers to take effect at or after death (811(c)) is probably the most confused and least understood of the entire Estate tax law. It has been productive of much litigation. The Courts as well as the Treasury Department have not been altogether clear or consistent in their positions on the identical issues. Both have reversed themselves at times, leaving the taxpayer and his counsel bewildered and uncertain as to what the next pronouncement would be.

In respect of transfers made prior to March 3, 1931, a remainder interest created by the decedent during his lifetime which takes effect after a life interest for the life of the decedent, whether life tenant was the decedent or not, is not includible in the gross estate: May v. Heiner, 281 U.S. 238 (1930).

In arriving at its decision in the Heiner case, the Supreme Court adhered to common law concepts of property and remainder interests. Applying this legalistic test to the transfer, it concluded that a vested remainder was a completed, present transfer and that the subsequent death of the transferor did not shift any interest in the property to the remainderman so as to render the transfer one which took effect at death.

To overcome the damaging effect of this decision upon the Federal revenue, Congress by Joint Resolution of March 3, 1931, amended section 811(c) of the Code to include transfers in which the transferor retained for his life or any period not ending before his death (1) possession or enjoyment of, or income from the property, or (2) the right to designate the persons who shall possess or enjoy the property or income therefrom.

This amendment is applied prospectively and not retroactively. Thus, transfers made prior to the adoption of the Joint Resolution by a decedent who died subsequent thereto are unaffected: Hassett v. Welch, 303 U.S. 303 (1938).

POSSIBILITY OF REVERTER

If the interest reserved by the decedent would have reverted to the decedent had he lived longer than the life beneficiary or beneficiaries, the property transferred will be includible in his gross estate. It is not material that the possession and enjoyment in the donee continued uninterruptedly from the time of gift: Helvering v. Hallock, 309 U.S. 106 (1940).

The evolution of this rule has itself had a tortuous history during which the United States Supreme Court changed its position three times within a period of nine years:

Klein v. U.S., 283 U.S. 231 (1931).
Helvering v. St. Louis Union Trust Co., 296 U. S. 39 (1935).
Helvering v. Hallock, supra. (1940).

Many problems followed in the wake of these decisions which remained unanswered. For instance, the Hallock case failed to answer the question whether the tax will be applicable to "any possibility of reverter" no matter how remote.

If not, where is the line to be drawn? To what extent will the property transferred subject to the decedent's possibility of reveter be included in his estate? There were three possible approaches on valuation. First, the total value of the property transferred; second, such value less the value of the intervening estates created for others than the decedent; third, the value of the possibility of reverter itself based upon accepted actuarial formulae. Previously, in two gift tax cases, the Supreme Court had adopted the last mentioned choice where the possibility of reverter was susceptible of valuation by the use of recognized actuarial standards but further declared that such a basis would not prevail if the valuation could not so be determined:

Robinette v. Helvering, 318 U. S. 184 (1943).
Smith v. Shaughnessy, 318 U.S. 176 (1943).

More recently, the Supreme Court by its decisions adopted the first method of valuation stated above and swept into the gross estate the total value of property transferred by the decedent in her lifetime over which she retained a possibility of reverter, if the life tenants predeceased her:

Fidelity-Philadelphia Trust Co. (Stinson Estate) v. Rothensies, 324 U.S. 108 (1945).

Commissioner v. Estate of L. Field, 324 U.S. 113 (1945).
Goldstone v. U.S., 65 S. Ct. 1323 (1945).

In its opinion in the Stinson case, the Court stated that the test of includibility is not to be made dependent upon the proximity or remoteness of the decedent's chance to regain the property under the possibility of reverter. It is sufficient if the decedent retained a string over the property transferred which made it uncertain until death who would own, enjoy or possess the property.

Thus, since the Hallock decision, the courts have struggled with the problem of where to draw the line. How remote a possibility of reverter can be was indicated in Estate of Goodyear, 2 T. C. 885 (1943), where the actuarial value of the reverter of a trust involving a corpus of $338,000 was .0000000000876, because the grantor to regain her property had to survive her son, the son's three children and their issue. The Commissioner contended that under the rationale of the Hallock case, the transfer should be includible in the decedent's gross estate for estate tax purposes. The court, however, held differently. The decisions are confusing and irreconcilable. See Lloyd's Estate v. Commissioner, 141 F. (2d) 758 (CCA-3, 1944) and Rothensies v. Fidelity-Philadelphia Trust Co., 112 F. (2d) 758 (CCA-3, 1940). See also, Commissioner v. Estate of Ballard, 138 F. (2d) 512 (CCA-2, 1943) and Commissioner v. Bank of Calif.,—F. (2d.)—(CCA-9, 1946).

By T. D. 5512, promulgated May 1, 1946, the Treasury Department has endeavored to achieve some semblance of order out of the chaos which exists.

The over all tests laid down by the Regulations require that the value of property transferred by a decedent in his lifetime is includible in his gross estate, if:

a. possession or enjoyment of the transferred interest can be obtained only by the beneficiaries who must survive the decedent, and

b. the decedent or his estate possesses any right or interest in the property (whether arising by the express terms of the instrument of transfer or otherwise). The regulations as amended by T.D. 5512 contain a series of examples intended to illustrate when the transfer will be taxable and under what circumstances the tax will not be imposed. Example 2, there given, reads as follows:

> "The decedent, during his life, transferred property in trust, giving the income therefrom to his son for life and the remainder to his son's surviving issue. If no issue survived the life tenant, the property was to revert to the decedent or his estate. This transfer does not satisfy requirement (a) of this section, since the life tenant's surviving issue need not survive the decedent in order to obtain possession or enjoyment of the property. Accordingly, no portion of the property is includible in the gross estate under this section."

This result follows the decision of the Tax Court in Francis Biddle Trust, 3 TC 832 (1944), (Pet. for Rev. dismissed, CCA-3, Sept. 20, 1945) which held that where the death of the grantor is not the intended event which enlarges the interests or enjoyment of the beneficiaries, the transfer is not taxable as a transfer to take effect at death.

To resolve doubts, all trust instruments should be reviewed promptly for the purpose of eliminating any possibility of reverter or to determine whether the transfer will be taxable for Federal Estate tax.

For further study of this difficult subject, see "The Hallock Problem: A Case Study in Administration" by Louis Eisenstein, 58 Harv. L. Rev. 1141 (1945); "Transfers with Possibility of Reverter" by Edward N. Polisher, Trusts & Estates, July, 1945.

REVOCABLE TRUSTS

There is also included in the gross estate of the decedent for estate tax purposes the interest of the decedent in any property transferred in trust or otherwise during his lifetime in which he reserved the power to alter, amend, revoke or terminate the transfer, either alone or in conjunction with any other person: I.R.C., Sec. 811(d).

Prior to the Revenue Act of 1936, the section dealing with revocable trusts was silent with respect to whether the capacity in which the power was retained and the source from which it was derived were of any consequence.

The Supreme Court's decision in White v. Poor, 296 U.S. 98 (1936) pointed up and answered these questions. It held that where the grantor gave the power to terminate the trust to the trustees but subsequently became one of the trustees, through appointment by the other trustees, such power was exercised by her, not by virtue of any reservation in the declaration of trust but rather by virtue of her appointment as trustee, and the property was, therefore, not includible in her gross estate. This is still the law with respect to trusts created prior to June 22, 1936.

Thereafter, to circumvent the obvious tax avoidance loopholes resulting from the decision in White v. Poor, supra, the statute was amended to read that the retention of such proscribed powers "in whatever capacity exercisable" and "without regard to when or from what source the decedent acquired such power" would be fatal to the transfer for estate tax purposes: Sec. 302(d) as amended by Revenue Act of 1936.

The Revenue Act of 1936 also added the word "terminate" to the list of forbidden powers. It was recently held, however, that the addition of this word in no way changed the law but merely made the new section declaratory of existing law since the power to terminate produces the same result as a "revocation" and is thus applicable to transfers made before 1936: Holmes v. Commissioner, —U.S.—(1946).

The terms "alter", "amend", "revoke" or "terminate" comprehend any situation where the grantor retains a power, regardless of how it is worded or what it may be termed, to vary materially the enjoyment of the property interests transferred in trust. The determining element is the presence of the power in the grantor to control by whom or in what proportion the income and corpus of the trust shall be enjoyed: Union Trust Co. of Pittsburgh v. Driscoll, 138 F. (2d) 152 (CCA-3, 1943) cert. den. 321 U.S. 764 (where the trustees, of whom the grantor was one, had the right to vary the interests of the beneficiaries); Holmes v. Commissioner, —U.S.—(1946) (where the grantor could terminate the trust and thus accelerate the time of enjoyment).

Nor is it of any tax consequence that a retained power remained unexercised at decedent's death and the trust property passed to originally designated beneficiaries. It is the *existence* of the power at the time of death, not its exercise, which causes the property to be included in the decedent's gross estate: McCaughn v. Fidelity Trust Co., 34 F. (2d) 443 (CCA-3, 1929); nor is it of importance that the grantor could not personally benefit through the exercise of such power: Porter v. Commissioner, 288 U. S. 436 (1933).

Any such power exercisable by the grantor alone or together with any other person, even though such other person has a substantial adverse interest, will result in the tax being imposed: Helvering v. City Bank Farmers Trust Co., 296 U. S. 85 (1936).

Where the power to terminate the trust is exercisable by persons other than the grantor, the property is not includible, although such persons might revest the property in the grantor: Commissioner v. Hall, 147 F. (2d) 946 (CCA-2, 1946). This is so despite the fact that the person possessing the power is the wife of the grantor. The possible power of the grantor to influence his wife to revoke the trust does not alter the situation: Kneeland et al, 34 BTA 816 (1936).

If the power can be exercised only as to a portion of the transfer, so much as may be affected will be includible in the gross estate. Thus, in a transfer of a life estate with a power retained which could only affect the remainder interests, the value of the remainder interests alone are includible in decedent's gross estate: Estate of Albert E. Nettleton, 4 T.C. No. 118 (1945).

Where the power retained is contingent upon the happening of a certain event and the circumstances indicate that the contingency has not and is not likely to occur, the transfer will not be taxable: Commissioner v. Ballard, 138 F. (2d) 512 (CCA-2, 1943); Helvering v. Tetzlaff, 141 F. (2d) 8 (CCA-8, 1944).

Similarly, if the decedent, having exercised the power, thereby extinguished it, the transfer is not includible: Estate of I. H. Burney, 4 T.C. 449 (1944).

PROPERTY HELD JOINTLY OR BY THE ENTIRETIES

The gross estate of the decedent includes the value of the interests held by the decedent as joint tenant with any other person or as tenants by the entirety by the decedent and spouse, or as community property, except such part as may be shown to have originally belonged to such person and was never acquired from the decedent for less than an adequate consideration in money or money's worth: Sec. 811(e)(1).

Property so held is presumed to be part of the decedent's gross estate, irrespective of when the tenancy was created. The burden is upon the surviving tenant to establish his contribution: U. S. v. Jacobs, 306 U. S. 363 (1939).

The community property provision inserted by the Revenue Act of 1942 treats such property for estate tax purposes in the same manner as jointly owned property, except that insofar as community property is concerned there is included at all events in the decedent's gross estate, such part of the community property as was subject to his power of testamentary disposition. The constitutionality of this provision was upheld recently in Fernandez v. Weiner, ——U. S.—— (December 10, 1945).

PROPERTY PASSING UNDER POWER OF APPOINTMENT

There is also included in the decedent's gross estate his interest in any property (1) passing under a general power of appointment or (2) a special power of appointment which could be exercised in favor of any beneficiary beyond the restricted class as defined in the Revenue Act of 1942 except charitable organizations described under Section 812(d) and 861(a)(3): I.R.C 811(f)(1) as amended by the Revenue Act of 1942.

Special powers of appointment within a class which includes only the spouse of the decedent, spouse of the creator of the power, descendants of the decedent or his spouse, descendants (other than the decedent) of the creator of the power or his spouse, spouses of such descendants, are exempt: I.R.C., Sec. 811(f) (2)(3).

Until July 1, 1946, a tax free opportunity is granted to release or reduce certain powers of appointment created before October 22, 1942, which exceed in scope the restricted power as defined in the Revenue Act of 1942. An extended release period is also provided for holders of such powers of appointment under legal disability and in the military service to a date not more than six months after the termination of such disability or military service.

The test is always the existence of the power, not its exercise by decedent. See: Polisher "Estate Planning and Estate Tax Saving" Chapter VIII (1943).

LIFE INSURANCE

Proceeds of insurance policies on the life of the decedent are includible in the gross estate of the decedent to the extent that they are (a) receivable by the executor; (b) receivable by all other beneficiaries, in the proportion that: (1) the premiums or other consideration paid for the insurance, directly or indirectly, by the decedent bear to the total premiums paid, or (2) with respect to which the decedent possessed any incidents of ownership in the policies at his death. In determining the amount of premiums paid by the decedent, if he owned any incident of ownership in the policies on or after January 10, 1941, (the date of the issuance of T.D. 5032), all premiums paid by him before or after that date are to be included. If, on the other hand, the decedent possessed no incident of ownership in the policies on or after January 10, 1941, only such premiums paid by him after that date need be considered: I.R.C., Sec. 811(g)(1) and (2) as amended by the Revenue Act of 1942.

The Revenue Act of 1942, which radically changed the prior tests for the includibility of insurance proceeds also abolished the $40,000 special exemption. All insurance proceeds are now, therefore, includible if they fall within any one of the statutory tests.

The treatment of insurance proceeds for estate tax purposes has had a tortuous history. The statutory provision prior to 1942 was as simple as it was ambiguous. It stated that policies taken out by decedent on his own life were includible in his gross estate. The exact meaning of the phrase "taken out by decedent upon his own life" was difficult to define and its definition varied from time to time. In the twenty-four years since the first inclusion of life insurance proceeds, the Treasury Department has changed its position five times in setting up tests for the determination of the question. The test in effect prior to January 10, 1941, the effective date of T.D. 5032, was "incidents of ownership." This amendment to the regulations made payment of premiums the sole criterion for the taxability of insurance proceeds.

The Code, as amended, establishes two alternative criteria of taxability for insurance policies payable to specific beneficiaries. One is the payment of premiums and the other is possession of incidents of ownership.

The inquiry now must be directed to:

1. What are incidents of ownership?
2. What will constitute indirect payments?

INCIDENTS OF OWNERSHIP

Incidents of ownership include the following: the power to change the beneficiary: Chase National Bank v. U. S., 278 U. S. 327 (1929); the power to surrender, cancel, assign, revoke an assignment, pledge the policy for a loan or obtain from the insurer a loan against the surrender value of the policy: Liebmann v. Hassett, 148 F. (2d) 247 (1945); the right of the insured or his estate to its economic benefits: Regulations 105, Sec. 81.27. It is also indicated that a power to change the beneficiary reserved to a corporation of which the decedent is the sole stockholder is an incident of ownership in the decedent: Report of Senate Finance Committee on Revenue Act of 1942, pp. 234-236.

Prior to the Act of 1942, the existence in favor of the decedent of the right to have the proceeds of the policy revert to his estate in the event that the designated beneficiary predeceased him was considered an incident of ownership. The Revenue Act of 1942 specifically eliminated such a reversionary interest in insurance policies as an incident of ownership which would compel the inclusion of proceeds in the decedent's gross estate. This change applies only to decedent's dying on and after October 22, 1942. As to estates of decedents who died before October 22, 1942, the retention of a reversionary interest by the decedent will be treated as an incident of ownership causing proceeds to be included in the gross estate in view of the Supreme Court decision in the Hallock case: Helvering v. Hallock, 309 U. S. 106 (1940); Bailey v. U. S., 31 Fed. Supp. 778 (1940), Cert. dismissed on stipulation, 311 U. S. 721 (1940).

DIRECT AND INDIRECT PAYMENT OF PREMIUMS

It is impossible to provide an exact definition of the phrase "directly or indirectly." Primarily, it is a question of fact depending upon the circumstances. On the one hand is the situation where a man supplies his wife with money for the purpose of paying the premiums. There can be no question that he has paid them indirectly although she performs the physical act of payment. Between that case and one where the wife actually pays the premiums out of her own estate, there are a host of doubtful situations including payments made by trusts, family corporations, or corporations which are merely the alter ego of the insured.

It has been held, however, that where the decedent makes a gift to his wife which is unrelated to the payment of insurance premiums and she subsequently uses part of that gift for such payments, it will not constitute an indirect payment: John E. Cain Estate, 43 B.T.A. 1133 (1940). So, too, where the donees of a gift of stock in 1935 sold the stock and purchased single premium policies with the proceeds in 1936, the court held that since the gift was complete and unconditional, there was no indirect payment of premiums: Dickson v. Smith, —Fed. Supp.—(S.D. Ind., 1945).

Payment of premiums by a corporation which is the "alter ego" of the decedent will constitute indirect payment: Regulations 105, Sec. 81.27. Just what percentage of stock the decedent must hold for a corporation to be regarded as his "alter ego" is a difficult question to determine. Where the decedent owned only 51% of the stock, the court refused to regard the corporation as his "alter ego:" Wilson v. Crooks, 52 F.(2d) 692 (1931); Estate of Doerken, 46 B.T.A. 809 (1942) Acq. 1942-1CB5. See also, Polisher "Estate Planning and Estate Tax Saving" Chapter X (1943).

CONCLUSION

No estate plan is sound that fails to take into account the amounts which the executors will need to discharge the estate's liability for debts, death charges and Federal Estate tax. Nor will it be effective if it neglects to make available to the decedent's executors, following his death, either the cash or the resources readily convertible into cash without sacrifice of estate assets to pay such items. For the very assets to which the decedent may anchor his estate plan to provide for his family, may prove to be those which must later be resorted to by the executors for conversion into cash to meet the death charges and estate taxes.

Moreover, effective estate planning contemplates a continuous relationship between the lawyer and his client for the purpose of frequent reviews of the program evolved in order to meet changing economic, tax and family conditions and to make certain that the estate plan still fulfills the client's current needs.

The moral of today's complex Federal estate tax structure is:

Never draw a will for a client until:

1. a complete estate inventory is compiled of all property which will be includible under the Federal estate tax statute;
2. the death charges and Federal estate tax are computed;
3. an analysis is realistically made of the resources from which the cash requirements of the executors to pay these items may be anticipated;
4. a program is arranged to provide such cash, if the present assets constituting the estate will not make it available without sacrifice of estate assets through forced sale;
5. recommendations are made to minimize the Federal estate tax which will be imposed at death;
6. all legal, economic and other tax factors which will cumulatively operate upon the testator's estate at his death have been painstakingly appraised and considered.

Merely drawing a will may prove a costly procedure to the client.